

**RMB: New countercyclical factor to break the vicious cycle****Monday, May 29, 2017****Highlights:**

- China announced the second technical tweak of daily RMB fixing mechanism in 2017.
- The change is not a surprise as our fixing model has already broken down since May.
- We are still not quite sure about what exact countercyclical factor is. It may take us another few weeks to quantify the factor in our fixing model.
- The latest adjustment with countercyclical factor when dollar weakens is the way to break RMB's vicious cycle and is likely to limit the downside risk for RMB.
- It shows that China may prefer a stronger RMB when dollar weakens although at the expense of transparency.
- The new mechanism may give China more discretionary power to fix the midpoint in future.

China announced to fine tune its daily RMB fixing mechanism again, the second tweak in 2017. A new “countercyclical factor” will be added into the calculation of RMB fixing.

Under the latest revision, the daily fixing will depend on three parameters including 4:30pm onshore USDCNY closing, the change of currency baskets as well as newly added countercyclical factor instead of previous two parameters.

The announcement of mechanism adjustment was not a surprise to us as our daily fixing model has broken down since mid-May and market has already started to speculate the possible fixing regime shift. The inclusion of countercyclical factor explained the stronger bias of daily RMB fixing amid broad dollar weakness for the past two weeks.

The inclusion of countercyclical factor is not the overhaul of fixing mechanism but can be considered as the second technical adjustment for fixing mechanism in 2017 after China shortened the calculation of the change of currency baskets to 15 hours from 24 hours in Feb. Both technical adjustments are designed to help reduce volatility in the daily fixing.

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**So what is exact the countercyclical factor?** Frankly speaking, we are not able to quantify at the current stage and it may take us a few weeks to eventually build into our fixing model. For corporate treasurers or investors, we think there is no point to focus too much on those technical issues. Instead, we think the story behind could be more telling.

### Background

The latest fine-tune was announced when expectation on dollar turned weaker due to unwind of Trump trade. Since April, broad dollar has given up most of gains since US President election in November 2016. The correction of dollar index has accelerated since early May after French President Election. However, the USDCNY spot has been stuck in the narrow range. As such, RMB index has fallen again to test the low of 92, lowest since the launch of index. This leads to concern that RMB may be trapped in the familiar vicious cycle, which depreciation expectation may build up again when dollar weakens. A stronger RMB fixing is the only way to break the vicious cycle. With the help of countercyclical factor, China is able to set the daily fixing stronger than expected consistently.

### Two technical adjustments of fixing mechanism in 2017

Technical adjustment	Background	Implications
<b>Feb2017:</b> shorten the calculation of the change of currency baskets to 15 hours from 24 hours	Expectations on stronger dollar	If Dollar Strengthens in Asian time, RMB Index will be likely to strengthen, as such, RMB fixing will be stronger under the new fixing regime.
<b>May2017:</b> inclusion of countercyclical factor	Expectations on weaker dollar	If Dollar weakens, the countercyclical factor may help set the RMB fixing stronger to limit the downside risk for RMB spot.

From the table above, although two technical fine-tunes of RMB fixing mechanism in 2017 came out at the different background, both serve the same purpose to lower volatility in RMB fixing during rising volatility in broad dollar. In particular, the latest fine-tune will help limit the downside risk for RMB when dollar weakens.

We think the latest change shows that China may prefer stronger RMB when dollar weakens, though it may be at the expense of transparency. The new mechanism may give China more discretionary power to fix the midpoint in future.

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